Global commercial real estate update: State of play heading into Q4 2024

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In most years, the fourth quarter has seen a significantly higher volume of global real estate transactions than the prior three quarters. We head into Q4 2024 expecting values to start to recover after 24 months of correction. Unlike most years, the recent increase in interest rates in many markets will keep the pace of transaction subdued through year-end, in our view. We have growing confidence that transaction activity is likely to re-accelerate in early 2025, and that the start of a new real estate value cycle is close at hand.

With slowing inflation, and the initial easing of interest rates in some European markets expected to be followed elsewhere, we believe that we're at the start of a new real estate value cycle. Looking ahead for the next couple of years, the macro environment will likely be one of ongoing short-term volatility in interest rates, in our view. We expect interest rates to fall from current levels but settle/normalize at higher levels than seen over the prior decade. Global gross domestic product (GDP)[1] growth is likely to be lower than the prior decade and also we expect greater divergence between markets.

The new real estate value cycle is expected to experience less benefit from cap rate compression compared to previous recoveries. As a result, achieving the best real estate returns, relative to the respective local market, will require a focus on property income growth and reliance on secular demand drivers that can mitigate an easing of the economic cycle. It also elevates the need to seek differentiated performance through market selection, because of the large historical gap between top- and bottom-performing markets.

1. Macro environment: Focus on income growth

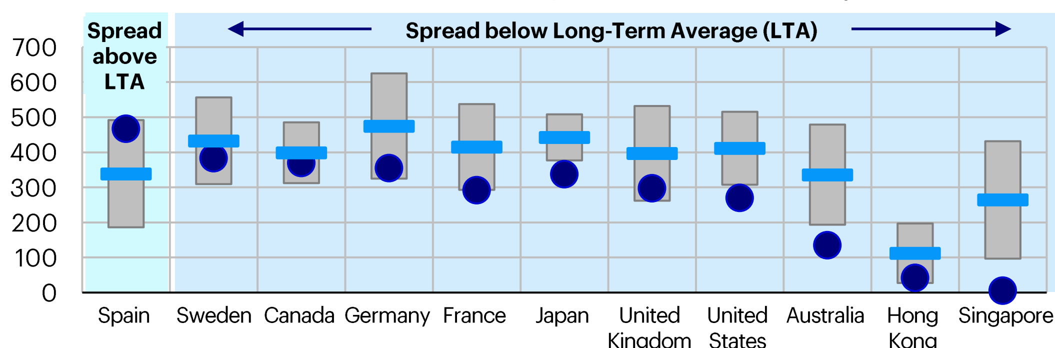
We expect three macro factors to be key in shaping returns:

Capital markets: Limited cap rate[2] compression to support return growth.
Over the past couple of decades, declining interest rates have led to declining commercial real estate (CRE) cap rates and helped drive value growth. Going forward, we expect declining interest rates to exert less influence on CRE cap rates.

Monetary policy loosening and global interest rate declines were essential to boosting liquidity during the past two decades. This resulted in real estate cap rates in almost all of the key global real estate markets maintaining a significant spread above the local 10-year government rate (see chart below). Equally important is that, for most markets, current cap rate spreads are either within one standard deviation[3] of the long-term range, or very close to that range, indicating that current pricing is not out of line with the historical levels.

Real estate cap rates: Significant spread above government rates

Yield/cap rate spreads over 10-year government bonds (basis points)[4]



Note: current spread is calculated as the spread between the Q1 2024 cap rate and the August 13, 2024. 10-yr government bond rate. Countries are ordered from left to right by current spread value after sorting by relative distance from LTA. LTA is the average since Q1 2007. Spreads at LTA are within +/-25 basis points of LTA.
Source: Invesco Real Estate using data from Real Capital Analytics and Macrobond as of August 2024. Past performance is not a guarantee of future results.

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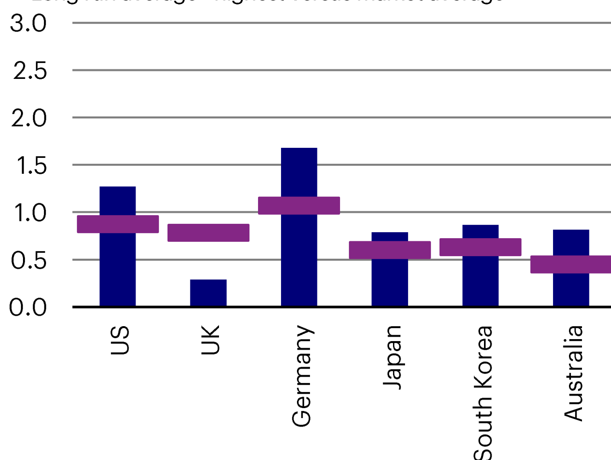
While current real estate pricing is in line with historic ranges in most markets, it's at the tighter end of that range. As a result, we expect cap rate compression will likely play a lesser role for real estate value growth, certainly until spreads move closer to the long-term average. Long-term government bond yields have moved out significantly over the past two years, but real estate cap rates have been slower to react because transaction evidence takes time to come through. The result is that the spread between real estate cap rates and interest rates has either been thin relative to history or inverted, driving CRE cap rates higher to restore an appropriate risk premium. Globally, it seems unlikely that longer term interest rates would return to the low levels that once prevailed in post-Global Financial Crisis years. As a result, we believe real estate cap rate compression will likely play a muted role in the recovery of CRE values over the next few years.

Economic conditions: Limited market-level real estate returns.
With cap rates likely to contribute little to real estate value growth, investors need to turn attention to income to drive returns. With the global GDP growth expected to be lower in the coming years than in the past couple of decades, real estate income growth is likely to be relatively lower. This means that property income will need more than cyclical drivers to accelerate growth. Stronger growth will likely either need to come from secular demand drivers, such as shifting demographics and advancing technologies, or from active management of individual properties to drive improvements and operating efficiencies in order to increase income.

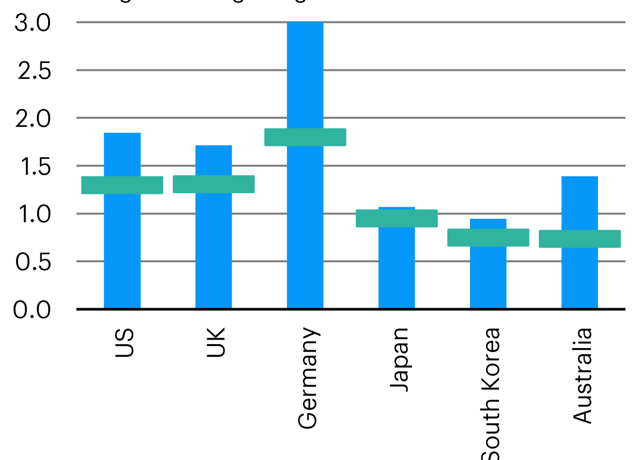
Sector pricing: Differences have rarely been wider.
Over longer periods of time we see fluctuations in the relative risk premia between real estate sectors, both globally and within individual markets. A key driver of these variations is changes in the outlook for income growth between the sectors. Those with a more positive growth outlook will likely trade more tightly than other sectors, all else being equal. The relative spread between sectors, however, varies significantly by market. The chart shows the current cap rate spread of the highest priced sector over both the market average and the tightest priced sector. It also compares these metrics to the long-run averages for each of these spreads. The key driver in these sentiment changes is the sector differences in expected growth and liquidity. A large element of this may be priced into the market already (more so than the past two decades), making the search for property income growth more challenging.

Significant cap rate variations (%) within markets

Highest sector cap rate versus market average



Highest sector cap rate versus lowest sector cap rate



Source: Invesco Real Estate, utilizing data from MSCI RCA as of August 2024. Sectors represented are office, industrial, retail, and residential, plus MSCI RCA's calculated market average cap rate for the period. Long run averages calculated from Q1 2008 when available for all markets.

2. Property income: Attractive growth available by differentiating

Differences between the characteristics of individual property sectors and geographic markets are key to finding stronger relative income growth opportunities.

By property sector

Our outlook for property sector income growth is based on each sector's exposure to long-term secular demand drivers, sensitivity to the economic cycle, and exposure to new supply within its local market. The chart below summarizes the key trends and how they vary by region.

Theme	Trend	Sectors affected	Regional/market variations
Long-term secular drivers	Growth of population share of seniors	Sectors for seniors: Medical office, life science, senior housing	Significant variations between markets in evolution of local demographic profile
	Changes in population share in the mid-30s and 40s	Sectors for transitional households: Single-family rentals, manufactured housing	• Variations in evolution of demographic profile • Nuances in underlying product demand • National economic development
	Changes in populations share in the mid-20s to mid-30s	Sectors for early-stage households: Apartments, particularly in urban markets	• Broadly similar demand patterns across key markets • Supply varies considerably
	Advances in technology	• Drives growth for industrial, life science, and data centers • Hinders growth for senior housing; tech allows seniors to age in place • Presents a challenge for office; enables remote working	• Generally global trends • Speed of influence varies tech adoption level and infrastructure quality
Economic cycle sensitivity	Acyclical sectors	Medical office, student housing	Similar global patterns
	Traditional cyclical sectors currently benefiting from low vacancy and supply		• US: Single-family rentals, manufactured housing, strip retail • Europe: Residential, urban logistics • AsiaPac: Residential, Australia logistics, Korean office • Globally: Data centers
	Traditional cyclical sectors currently impaired by high vacancy and supply		• US: Industrial, life science, • AsiaPac: China/HK office and Korea logistics
	Traditional cyclical sectors currently impaired by high vacancy and secular headwinds		• US: Traditional office • Europe: Non-CBD office
New supply exposure	Sectors with high current supply deliveries		• US: Industrial, apartments, self-storage, life science • AsiaPac: Korea and Japan logistics, China office
	Outlook after 2024	• Recent global interest rate increases sharply curbed new construction starts in most markets • Deliveries of new supply in most sectors set to be reduced through 2025 and 2026.	

These drivers are playing through differently in each market. Some local sectors may deliver stronger property income growth over the next one-to-two years, while others over a longer time horizon. The key differentiating factors between these shorter- versus longer-term outlooks is the relative near-term picture of supply relative to demand, and the strength of the structural factors that will drive ongoing demand.

By geography

Income growth within local real estate markets reflects a number of specific factors, such as political and geopolitical considerations. Also, tenant demand for each property type is driven by unique factors, which can vary considerably by location. For example:

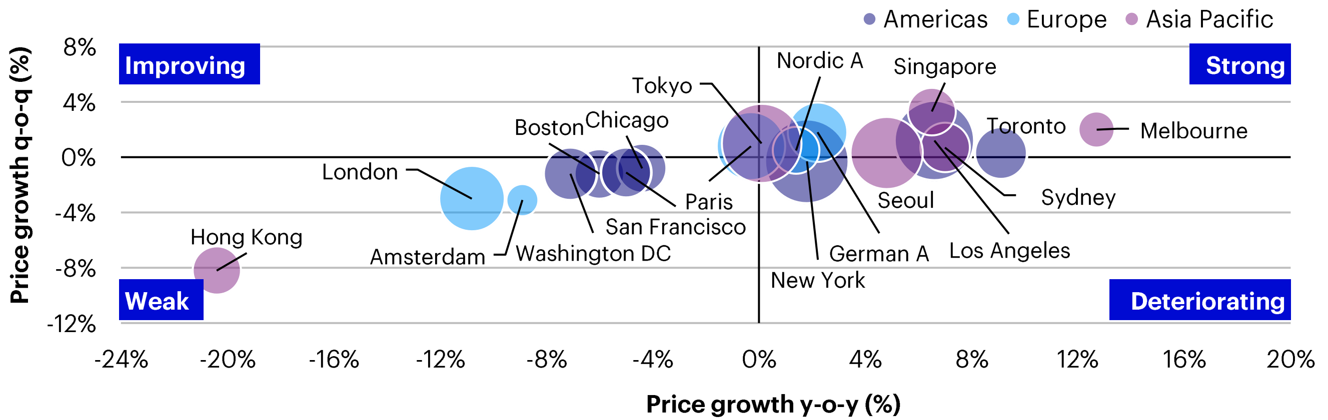
- Proximity to the nearest port and local consumer density for industrial demand
- Relative mix between home and in-office working for office demand
- Student-age population growth for student housing demand

It's also influenced by common factors, demographic growth being the most dominant.

The investment implications of demographic shifts reflect both macro and localized trends. We see considerable variation between different countries, and also within countries. These are key drivers of income growth and real estate returns, which highlights the need for local knowledge and analysis for specific real estate assets and investment decisions.

Shifting price momentum across markets as valuations trough

Change in momentum of price appreciation latest quarter compared to prior year – (Q2 2023 – Q1 2024) (%)



Source: Invesco Real Estate based on data from Real Capital Analytics as of March 2024. Note: Change in Real Capital Analytics Commercial Property Price Index (based on industrial, office and retail properties valued at USD$10 million or more). Size of bubble determined by the volume of transactions Q2 2023-Q1 2024).

3. Why differentiation matters

Relative performance across real estate portfolios is driven by thematic differences in portfolio concentrations. Key themes include sector, market, and location exposures, and asset characteristics.

Sector

Sector-level themes tend to reflect long-term secular drivers that boost demand over-and-above normal cyclical growth. For example, relative performance over the past decade has been largely defined by whether a portfolio held an overweight or underweight exposure to the burgeoning industrial sector. Secular trends go through roughly four performance stages.

1. **Emergence:** Tenant demand undergoes outsized growth and returns surge**.**
2. **Recognition:** Investors pay up to gain exposure to the growth trend and developers accelerate construction activity to meet higher levels of demand.
3. **Deceleration:** The tenant demand trend starts to moderate, but market pricing hasn't adjusted to moderated growth.
4. **Normalization:** The secular driver has run its course and related real estate demand reverts to a normalized long-term growth rate.

When we assess where the secular demand drivers are for industrial (or any other sector) along these four stages, we can't assume that the coming decade will be like the last one. These trends are dynamic, and we will update our views as we anticipate shifts.

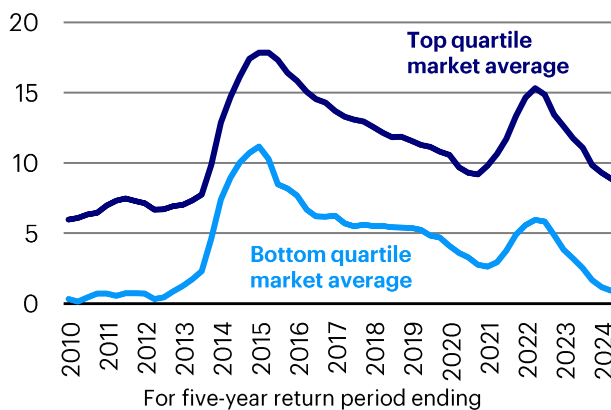
Market

There can be marked differences in market-level performance within single sectors within individual countries. Consider US apartment markets. The difference between five-year rolling returns for top-quartile performing markets versus bottom-quartile has consistently ranged from 5% to more than 8%. (See chart below) Individual markets move in and out of the top-quartile and bottom-quartile positions due to the ebb and flow of market prices, changes in supply levels, operating expenses, or capital expenditures, as well macro-economic drivers and local migration patterns. While the market composition in the top and bottom positions can change over time, the consistent performance gap between the best and worst markets within a property type is a big reason why market differentiation matters.

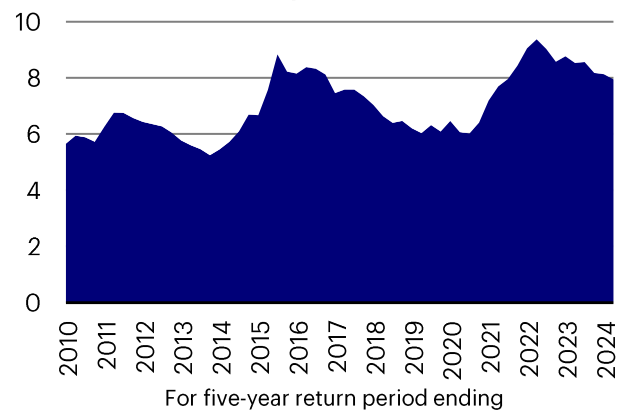
Market selection matters — US apartment example

Annual five-year rolling total return for apartments (%)

Top quartile markets versus bottom quartile markets



Difference between top quartile average and bottom quartile average



Sources: Invesco Real Estate, utilizing data from NCREIF as of July 2024. Past performance is not a guarantee of future results.

4. Investment strategy: Where to find better relative value

Relative performance across different profiles of real estate opportunity and risk can change over the value cycle. Let's look at current relative value prospects for a couple of these profiles.

Buy versus build

Commercial real estate prices and construction costs have moved in opposite directions since the start of COVID-19. Using US data from Q1-2020 to Q1-2024, average prices fell by 9%[6] while average construction costs rose by 33%.[7] This trend holds in most global real estate markets. Real estate valuations declined as a result of the higher interest rate environment, while construction costs suffered from inflation globally. In many markets the price of recently delivered product can provide better relative value than building from scratch.

Equity versus debt

Global real estate equity values have largely corrected, albeit with some further adjustments still coming through in the US. The recent increase in global interest rates, resulted in the cost of borrowing debt against real estate assets also increasing considerably. In most key global real estate markets, cap rates are now back above the cost of borrowing, but with a tighter spread than in recent years. The result is much tighter difference in returns between real estate equity and real estate debt versus recent history, despite their inherent risk differences. That's why we believe CRE real estate debt, based on current market conditions, offers an attractive risk-adjusted relative value in many markets. Once base interest rates and CRE debt rates start to fall, however, we expect the equity-versus-debt comparison will move along a spectrum. We believe that should improve the attractiveness of CRE equity opportunities while still offering higher debt yields than the 2010s' cycle, but lower than recent peaks.

5. Public policy: Local policies impact CRE more directly than national ones

While political events, particularly national elections, create considerable interest, the longer-term nature of real estate typically insulates its returns from shorter-term election cycles. Instead, real estate is impacted more by changes at a local level of factors such as property taxes, insurance, landlord and/or tenant protections, and the zoning/permitting of land.

As we head into Q4 2024, global attention will be on the US election. We're also watching for any policy shifts following the European Union and French elections earlier in 2024, though we expect relatively limited changes in the UK following the change of government there.

Conclusion: Need for property income growth

Strong property income growth will be needed to drive better relative returns into the new real estate value cycle, resulting from less cap rate compression than experienced in previous recoveries. Income growth faces near-term challenges because global economic growth is expected be lower than in prior decades.

We also expect to see greater de-synchronization than in recent years. In most key global markets, current real estate pricing largely reflects different sector expectations for income growth and liquidity. This accentuates the need for reliance on secular drivers that can mitigate an easing economic cycle. It also elevates the need to seek differentiated performance through market selection, because of the historical gap between top- and bottom-performing markets. We expect that the current risk-adjusted advantage of CRE debt over equity (where CRE debt is available) should eventually even-out as interest rates reduce from peak levels.

Geopolitical considerations remain key risks to the outlook, but overall we believe that the recent correction in values offers attractive entry points into the sector. Also, recent reductions in development pipelines are expected to shift the supply/demand balance more into the favor of the asset owner landlord. While global and macro factors are continuing to drive real estate returns, we believe that over the next couple of years local knowledge will be particularly important for driving relative outperformance.

Defined Terms and Notes

1. Gross domestic product (GDP) is a broad indicator of a region's economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time.
2. Capitalization rates (cap rates) is the quotient of a property's net operating income divided by the property's estimate value.
3. Standard deviation is a statistic that measures the dispersion of a dataset relative to its mean.
4. Basis point (bps) is a unit that is equal to one one-hundredth of a percent.
5. Correlation indicates the degree to which two investments have historically moved in the same direction and magnitude.
6. Based on the percent value change of the Green Street Commercial Property Price Index, equal-weighted, from March 1, 2020 to April 1, 2024.
7. Based on the percent value change of the Engineering News Record (ENR) Building Cost Index published by McGraw-Hill, from Q1-2020 to Q1-2024. The Engineering News Record (ENR) Building Cost Index is calculated from wage rates and materials prices for the U.S. and each of the 20 metro areas reported. It applies to general construction cost. The dataset includes 20 metro areas in the United States.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested. Property and land can be difficult to sell, so investors may not be able to sell such investments when they want to. The value of property is generally a matter of an independent valuer's opinion and may not be realised.

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